

**SOAH DOCKET NO. 473-00-1017
PUC DOCKET NO. 22352**

APPLICATION OF CENTRAL	§	BEFORE THE STATE OFFICE
POWER & LIGHT COMPANY FOR	§	
APPROVAL OF UNBUNDLED	§	
COST OF SERVICE RATE PURSUANT	§	OF
TO PURA § 39.201 AND PUBLIC	§	
UTILITY COMMISSION	§	
SUBSTANTIVE RULE 25.344	§	ADMINISTRATIVE HEARINGS

**DIRECT TESTIMONY
AND EXHIBITS
OF
LEE SMITH**

**ON BEHALF OF
THE TEXAS RETAILERS ASSOCIATION
AND
THE TEXAS HOSPITAL ASSOCIATION**

November 17, 2000

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1 Part I. INTRODUCTION

2 Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

3 A. My name is Lee Smith, and I work for La Capra Associates, 333 Washington St., Boston,
4 Massachusetts.

5 Q. WHAT IS YOUR OCCUPATIONAL EXPERIENCE?

6 A. I am a Senior Economist at La Capra Associates. I have been with this energy planning
7 and regulatory economics firm for 16 years. Prior to my employment at La Capra
8 Associates, I was Director of Rates and Research, in charge of gas, electric, and water
9 rates, at the Massachusetts Department of Public Utilities. Prior to that period, I taught
10 economics at the college level. My resume is attached as Exhibit LS-1.

11 Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

12 A. I am testifying on behalf of the Texas Retailers Association ("TRA") and the Texas
13 Hospital Association (hereinafter "THA"). The members of this group are retail
14 customers of the Central Light and Power ("CPL" or "Company") and together are a
15 significant stakeholder in the Texas electric industry restructuring proceedings.

16 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

1 A. I am testifying as to the revenue requirement claim put forth by CPL in Docket No.
2 22352 to develop unbundled rates for the 2002 forecast year when competition opens in
3 Texas.

4 **Q. WHAT IS YOUR EXPERIENCE IN ELECTRIC INDUSTRY**
5 **RESTRUCTURING?**

6 A. I have assisted in rulemaking for a restructured industry and in drafting legislation in
7 Massachusetts, and was a member of a number of several New England Power Pool
8 ("NEPOOL") committees that created the New England Independent System Operator. I
9 have addressed restructuring issues in Maine, New Hampshire, and Vermont. I
10 contributed to testimony in New Jersey for the Division of the Ratepayer Advocate. I
11 testified in eight cases in Pennsylvania on rate unbundling and retail market generation
12 costs, and continue to advise the Office of the Consumer Advocate. In Maryland, I
13 assisted the Office of the People's Advocate in electric restructuring cases. I advised the
14 Ohio Consumer's Counsel on stranded costs and rate issues. I have testified in Arizona
15 on stranded cost and retail restructuring for the Commission staff in numerous cases. In
16 Arkansas I have been advising the Public Service Commission on various issues.

17 **Q. WHAT IS YOUR EXPERIENCE IN ELECTRIC COST OF SERVICE ISSUES?**

18 A. Since leaving the Massachusetts DPU, I have performed cost studies and prepared rate
19 design for over twenty utilities in at least eleven states. I have developed cost of service
20 studies and designed rates for a number of utilities. I have advised Commissions,
21 consumer advocates, and other interested parties on cost of service, cost allocation, and
22 rate design issues.

1 **Q. HOW IS YOUR TESTIMONY ORGANIZED IN THIS PROCEEDING?**

2 A. First I analyze the appropriateness of the costs relating to support services in CPL's
3 depiction of both historic and forecast test year costs. Next I analyze various adjustments
4 proposed by CPL to both distribution and transmission test year costs.

5 **Part II SUPPORT SERVICES**

6 **Q. PLEASE SUMMARIZE THE PURPOSE OF THIS PART OF YOUR**
7 **TESTIMONY.**

8 A. The purpose of this part of my testimony is to comment on the \$45.3 million of affiliate
9 support services costs to be billed to CPL's Energy Delivery Company ("EDC") by
10 Central and South West Services and included in the 2002 forecast year cost of service.¹
11 I focus on the proposed adjustment to historic test year support services costs, the
12 proposed *pro forma* adjustments related to alleged new activities mandated by SB7, and
13 the projected increase in costs due to price escalation through the end of the forecast test
14 year.

15 **Q. PLEASE DESCRIBE THE STRUCTURE OF THE ORGANIZATION**
16 **RESPONSIBLE FOR PROVIDING SUPPORT SERVICES TO CPL DURING**
17 **THE HISTORIC TEST YEAR.**

18 A. CPL received services from several affiliate companies during the test year, including
19 CSWS. At that time, CSWS was a wholly owned subsidiary of CSW and the corporate
20 service company for the CSW System. The support services provided by CSWS to CPL
21 and other CSW subsidiaries were priced at cost with no profit added, as required by SEC
22 rule.

23 **Q. WHAT TYPES OF SERVICES DID CSWS PROVIDE TO CPL DURING THE**
24 **TEST YEAR?**

¹ Schedule VI-N-1B 10/02/2000 Update

1 A. CSWS provided CPL and others with a variety of services. For example, CSWS's
2 Operations Services organization provided the following services during the test year:
3 Information Technology services; telecommunications services; general services,
4 including office services, fleet services, and real estate services; and risk management
5 services, including insurance procurement, claims processing, and employee/public
6 safety.² Other CSWS organizations that provided services to CPL during the test year
7 were Customers Services, Supply Chain Services, Human Resource Services,
8 Communications Services and Power Generation Services. Some of the personnel that
9 performed these services for specific utilities were employed by and located at the utility
10 but managed centrally by CSWS. These employees were, however, centrally managed
11 by the responsible services organization at CSWS.

12 Q. **WHAT TYPES OF COST WERE INCURRED BY CSWS IN PROVIDING**
13 **SERVICES TO CSW SUBSIDIARIES?**

14
15 A. The expense categories include depreciation and amortization, maintenance of structures,
16 salaries and wages, outside services; property insurance; injuries and damages; employee
17 pensions and benefits; advertising and rents and leases.

18 A. **Historic Test Year Support Services Costs**

19 Q. **WHAT WAS THE TOTAL COST OF SUPPORT SERVICES PROVIDED BY**
20 **CSWS TO CPL DURING THE HISTORIC TEST YEAR?**

21 A. CPL was billed a total of \$164.8 million by several affiliate companies during the historic
22 test year.³ Of that total, \$76.7 million was billed by CSWS,⁴ on a per books basis. With
23 adjustments included, the CSWS billings increased to \$78.2 million,⁵ of which about

² These services and the associated costs for the historic and forecast test years are included in the testimonies of Debbie Potter.

³ Schedule VI-N-1A, Revised 10/02/00

⁴ Schedule VI-N-2A, Revised 10/02/00

⁵ Ibid.

\$38.3 million was allocated to the transmission and distribution (T&D) functions.⁶

Q. PLEASE EXPLAIN THE TEST YEAR REQUESTED ADJUSTMENTS TO THE CSWS COSTS BILLED TO CPL.

A. The total adjustment is about \$1.5 million⁷ and comprises several components, the largest of which relates to a proposed increase in O&M expenses for certain payroll costs of CSWS employees that worked on activities related to the merger of AEP and CSW Corp. during the historic test year.⁸ Originally, those costs were not charged to CPL but instead to CSW Corp.

Q. DO YOU AGREE WITH THE PROPOSED ADJUSTMENT TO CSWS TEST YEAR BILLINGS TO RECOVER THE MERGER-RELATED PAYROLL COSTS?

A. No. The Company's argument in support of adding back the payroll costs of CSWS employees assigned to the merger should be rejected. If accepted, it would mean that shareholders would recover these costs twice. The first time would be through the resulting increase in rates, relative to what the rates would have been had the adjustment not been included. The second time would be through retained merger benefits.

Q. PLEASE EXPLAIN HOW SHAREHOLDERS WOULD RECOVER THESE LABOR COSTS A SECOND TIME THROUGH THE RETENTION OF MERGER BENEFITS.

A. The merger of AEP and CSW is expected to create significant cost savings in the regulated businesses that will be realized over the long term. The settlement agreement that resolved the merger proceeding allows shareholders and customers to share in the merger-related cost savings, net of reasonable costs to achieve. That is, customers do not share in the merger savings until the merger parties have fully recovered all reasonable merger-related costs to achieve, including the payroll costs of employees assigned to the

⁶ Schedule VI-N-1B, Revised 10/02/00.

⁷ Schedule VI-N-2A, Revised 10/02/00.

⁸ Schedule VI-N-6A, Revised 10/02/00.

1 merger. Thus, CSWS should seek recovery of its merger-related payroll costs from CSW
2 Corp rather than through an adjustment to test year client billings.

3 **Q. DOES THE ABOVE ARGUMENT APPLY TO ALL MERGER-RELATED**
4 **PAYROLL COSTS CHARGED TO CSW, REGARDLESS OF THE SUBSIDIARY**
5 **THAT INCURRED THOSE COSTS?**

6 A. Yes. The Company has included in its revised filing a merger-related adjustment to test
7 year O&M expenses totaling about \$4.4 million, of which \$2.8 million has been
8 functionalized to the T&D functions that will remain regulated after 2001.⁹ I recommend
9 that the full \$2.8 million plus escalation, or \$3 million, be removed from the 2002
10 forecast year O&M expenses.¹⁰

11 **Q. DOES THE ABOVE MENTIONED \$3 MILLION INCLUDE THE CSWS**
12 **MERGER-RELATED PAYROLL COSTS DISCUSSED EARLIER?**

13 A. Yes.

14 **Q. IS THERE A SECOND REASON WHY YOU BELIEVE IT IS APPROPRIATE**
15 **TO EXCLUDE MERGER-RELATED PAYROLL COSTS FROM TEST YEAR**
16 **O&M EXPENSES?**

17 A. Yes. If the Company's request to add back the payroll costs charged to CSW is
18 approved, customers will in effect be subsidizing the business expansion goals of the
19 merger parties and their shareholders. Historically, the principal driver of utility mergers
20 was the expectation of large savings from the synergies of combined company
21 operations. While cost savings remain an important factor in merger decisions, it is
22 competition that is fueling the current wave of mergers. Mergers enable utilities to
23 position themselves to deal more effectively with competitive threats and to grow their
24 businesses, particularly in the non-regulated sectors. The captive customers of regulated
25 businesses should not be required to finance these profit making opportunities if they are
26 not sharing in the resulting profits.

⁹ Cities 33-97.

1 **Q. PLEASE EXPLAIN YOUR CONCERNS REGARDING THE TEST YEAR COSTS**
2 **BILLED TO CPL BY CSWS.**

3 A. My first concern is that the Company has made no attempt to demonstrate that the
4 services provided to it by CSWS in the test year were necessary to the performance of its
5 various duties. For example, while it is reasonable to assume that the efficient
6 performance of those duties requires some level of IT support, it does not follow that
7 CPL's operations would have been adversely affected if some of those services had been
8 eliminated or their level reduced. Without a detailed and thorough analysis of the need
9 for each service, the Company cannot meet its burden of showing that the support
10 services costs incurred in the test year are reasonable. My second concern is that no
11 analysis was conducted to determine whether the costs of the various support services
12 provided by CSWS exceeded the costs billed by other service providers to other utilities.
13 In short, the Company has requested that the Commission find its support services costs
14 to be reasonable and necessary without ever providing the Commission with an
15 appropriate basis for making that finding, such as a necessity analysis.

16 **Q. WHAT DOES A NECESSITY ANALYSIS ENTAIL?**

17 A. A necessity analysis typically involves reviewing all support services activities in order to
18 determine the business driver or drivers creating the need to perform each activity.
19 Although the business drivers will vary for each service company, they typically include
20 corporate governance, regulatory (including environmental compliance), management
21 control and strategic planning. As noted above, the Company filing is silent on this issue.

22 **Q. REGARDING YOUR SECOND CONCERN, WHAT IS THE BASIS OF YOUR**
23 **CLAIM THAT NO ANALYSIS WAS CONDUCTED TO DETERMINE THE**
24 **OVERALL COST OF CSWS SERVICES RELATIVE TO OTHER PROVIDERS?**

¹⁰ See Exhibit LS-X.

1 A. The Company stated in response to discovery that no cost studies had been conducted to
2 support the prices charged by CSWS.¹¹

3 **Q. HOW DO YOU RESPOND TO THE CLAIM BY MS. POTTER IN HER**
4 **OCTOBER 2 TESTIMONY THAT CSWS'S IT ORGANIZATION FARED 10%**
5 **TO 59% BETTER THAN THE MEDIAN OF OTHER ORGANIZATIONS**
6 **INCLUDED IN THE 1998 META GROUP STUDY?**

7 A. Ms. Potter did not claim that all CSWS support services fared better than other providers.
8 The Meta Group study is a good example of the kind of benchmarking exercise that
9 services organizations such as CSWS should undertake to demonstrate that the costs of
10 their services are at least comparable to those of other providers. If conducted carefully,
11 benchmarking can be a very effective tool in determining whether a company's business
12 practices are reasonable and cost effective. However, as shown in Chart 1 to Ms. Potter's
13 testimony, IT accounted for only half of the costs billed by CSWS's Operations Services
14 to T&D functions in the test year. Further, Operations Services was responsible for only
15 about 38% of the total CSWS costs allocated T&D functions in the historic test year.
16 Thus, the Company's filing fails to address the reasonableness of a significant portion of
17 the test year support services costs.

18 **Q. WHAT ABOUT THE ELECTRIC UTILITIES COST GROUP (EUCG)**
19 **BENCHMARKING STUDY MENTIONED IN THE AMENDED TESTIMONY OF**
20 **MR. KISSMAN?**

21 A. Although discussion of EUCG study appears in a section of Mr. Kissman's testimony that
22 is labeled "Reasonableness of [CSWS] Costs", its purpose was actually much broader
23 than support services costs. According to Mr. Kissman's own testimony, the objective of
24 the EUCG study was not to compare support services costs but rather T&D utility
25 performance in the areas of O&M costs, reliability, and safety.¹² Since O&M costs
26 include much more than support services costs, little can be said about a utility's

¹¹ See response to Cities 3-27.

¹² Amended Direct Testimony of Preston Kissman, page 35.

performance in one area of cost by determining its relative cost position in another area.

Q. WHAT PORTION CPL'S TOTAL O&M EXPENSE FOR THE T&D FUNCTION IS ATTRIBUTED TO SUPPORT SERVICES?

A. Using the Company's projection for the forecast year, I estimate that support services costs billed by CSWS account for no more than 35% of total T&D company O&M expense.

Q. GIVEN THE COMPANY'S FAILURE TO DEMONSTRATE THE NECESSITY AND REASONABLENESS OF THE TEST YEAR SUPPORT SERVICES AND COSTS, WHAT ACTIONS DO YOU RECOMMEND?

A. The Company's failure to comply with the requirements of PURA § 36.058¹³ would justify disallowance of all allocated (as opposed to direct billed costs) CSWS costs to CPL in the historic test year, or \$26.4 million. Direct billed costs are costs that are incurred to meet specific needs of clients and therefore the underlying services are less likely to be categorized as unnecessary or surplus to requirements. If the Commission determines that such cost disallowances would be too severe a penalty, an alternative would be to disallow the proposed proforma adjustments to test year O&M expenses until such time that the requirements of PURA § 36.058 have been fulfilled. These adjustments are described and discussed later in my testimony.

Q. PLEASE DESCRIBE THE ORGANIZATIONAL STRUCTURES OF CPL AND CSWS IN THE 2002 FORECAST YEAR.

A. As discussed above, the transmission and distribution assets of CPL will be transferred to the EDC and the generation assets to the Power Generation Company (PGC). In addition, a Retail Electric Provider will be created to provide retail services to CPL's customers. Further, some of the services currently provided by CSWS will be provided

¹³ All references to PURA are to TEX. UTILITY CODE ANN. §§ 11.001-64.158 (Vernon 1998 and Supp. 2000) (Public Utility Regulatory Act)

1 in the future by an AEP shared services organization. Others will be provided by the
2 EDC through its T&D Central Operations organization.

3 **Q. IS CPL REQUESTING AN INCREASE IN REVENUES TO RECOVER AN**
4 **EXPECTED INCREASE IN SUPPORT SERVICES BILLED BY CSWS AND**
5 **T&D CENTAL OPERATIONS IN THE 2002 FORECAST YEAR?**

6 **A.** Yes. In its initial March 31, 2000 filing, CPL sought approval to recover about \$50
7 million in supports services costs allocated to the regulated T&D functions. That amount
8 included approximately \$10 million of proforma adjustments to the historic test year
9 costs and approximately \$5 million for price escalation. As a result of the Commission's
10 Order No. 25, the Company revised its earlier estimate and is now seeking approval to
11 recover about \$45.3 million in the 2002 forecast year. This 18% increase over the
12 adjusted historic test year amount is attributed by the Company to several SB7-related
13 proforma adjustments totaling \$3.9 million and price escalation on the test year amount
14 plus proforma adjustments totaling \$3.1 million.

15 **Q. PLEASE DESCRIBE THE ADJUSTMENTS AND STATE WHETHER OR NOT**
16 **YOU SUPPORT THEM.**

1

2 A. The *pro forma* adjustments are described in the amended direct testimony of Company
3 witness Joe Lambright and summarized in his Exhibit DJL-4. Out of a total of \$14.7
4 million, \$3.9 was functionalized to regulated T&D and assigned to CSWS.¹⁴ The single
5 largest *pro forma* adjustment to support services costs is to establish an organization to
6 interact with REPs and other users of the transmission system. My position on this
7 adjustment, and on the adjustment to recover new REP registration and billing expenses,
8 is presented in Part III of this testimony.

9 Q. DID THE COMPANY ADJUST ITS HISTORIC TEST YEAR SUPPORT
10 SERVICES COSTS FOR THE EFFECTS OF INFLATION WHEN
11 CALCULATING ITS 2002 FORECAST?

12 A. Yes. In his October 2, 2000 testimony, Mr. Lambright describes the process he used to
13 escalate test year O&M and A&G expenses provided to him by Mr. Broad using the
14 generic escalation factors in Order No. 25. Mr. Lambright also applied the generic
15 escalation factors to the *pro forma* adjustments mentioned above. These calculations
16 produced a total increase in costs of \$5.9 million.

17 Q. DID THE COMPANY IDENTIFY THE PORTION OF THE \$5.9 MILLION
18 INFLATIONARY INCREASE THAT WAS FUNCTIONALIZED TO THE
19 REGULATED T&D OPERATIONS AND ASSIGNED TO CSWS?

20 A. Yes. As noted above, the Company is requesting recovery of an inflationary increase in
21 CSWS support services costs of \$3.1 million.

22 Q. DO YOU HAVE ANY CONCERNS WITH THIS ESTIMATE?

23 A. Yes. Although the Company has identified in Schedule VI-N-1B to its October 2 filing
24 the cost increase by FERC account number due to price inflation, and described in Mr.
25 Lambright's revised testimony how the generic escalation factors approved in Order No.
26 25 were applied, it omitted to provide a schedule that identifies the factor that was

¹⁴ Schedule VI-N-2B.

1 applied to each sub-account. This omission is important because the overall inflationary
2 increase requested by the Company for support services costs is 7.43%, very close to the
3 maximum increase allowed under Order No. 25 assuming all costs are escalated using the
4 largest approved factor. On the assumption that certain support services costs do not
5 increase with inflation and that others are escalated using smaller factors, one might
6 expect a lower overall inflationary increase. For example, materials and services costs
7 related to T&D can increase no more than 2.3% and labor costs classified as Other can
8 increase no more than 7.3%.

9 **Q. WHAT DO YOU RECOMMEND?**

10 A. I recommend that the Commission condition its approval of any inflationary cost increase
11 on the Company providing further support for the escalation factors applied to each sub-
12 account.

13 **Q. THE ABOVE CONCERN NOTWITHSTANDING, WHAT INFLATIONARY**
14 **COST INCREASE DO YOU RECOMMEND GIVEN YOUR POSITION ON THE**
15 **TEST YEAR AND PROFORMA SUPPORT SERVICE COST ADJUSTMENTS?**

16 A. My recommended changes to the Company's test year and proforma adjustments would
17 reduce the allowed annual escalation by about \$435,000.

18 **Part III CLAIMED INCREASES IN DISTRIBUTION AND**
19 **TRANSMISSION COSTS**

20 **Q. WHAT IS THE PURPOSE OF THIS PART OF YOUR TESTIMONY?**

21 A. I analyze and suggest modifications to several of the Company's proposed adjustments
22 to historic test year costs of transmission and distribution. I also critique the Company's
23 requested increase in T&D rate base.

24 **Q. WHAT IS THE INCREASE IN TEST YEAR DISTRIBUTION REVENUE**
25 **REQUIREMENTS REQUESTED BY THE COMPANY IN ITS OCTOBER 2**
26 **FILING?**

1 A. The Company's distribution cost of service for the forecast year is 28% higher than the
2 historic test year revenue requirement. The O&M component of the cost of service
3 increases by 22%. The historic year itself has never been critically examined by the
4 Commission and may include costs that do not appropriately belong in the distribution
5 cost of service. In part II I have discussed various components of and adjustments to the
6 "historic year".

7 **Q. HOW MUCH OF AN INCREASE IN TRANSMISSION REVENUES IS THE**
8 **COMPANY REQUESTING IN ITS REVISED FILING?**

9 A. The Company has proposed to increase transmission revenue requirements by 70% over
10 the test year level, including an increase of 118% in return on ratebase.

11 A. Expense Adjustments

12 **Q. PLEASE DISCUSS THE COMPANY'S REQUESTED ADJUSTMENTS TO**
13 **DISTRIBUTION O&M EXPENSES.**

14 A. The Company makes a number of expense adjustments associated with what it describes
15 as new activities resulting from SB7.

16 **Q. WHAT ARE THE COMMISSION'S INSTRUCTIONS IN ORDER 25**
17 **REGARDING PROJECTED COSTS?**

18 A. The Commission specified the escalation rates that are to be applied to different types of
19 operation and maintenance expenses. The only additional adjustments that may be made
20 are for services that were not provided in the historic year but that will be required by
21 restructuring.

22 **Q. WHICH WITNESS ADDRESSES THE EXPENSE ADJUSTMENTS**
23 **ASSOCIATED WITH WHAT IS DESCRIBED AS NEW ACTIVITIES**
24 **RESULTING FROM SB7?**

25
26 A. Several different witnesses discuss so-called new activities, which are categorized in the
27 Distribution, Customer Service, and Operations Services functions. Mr. Kissman

1 discusses distribution function expenses, including a Transmission Access adjustment.
2 Mr. Hooper describes several other "new activities" that will occur under a "new"
3 Distribution Customer Services group. Ms. Potter discusses increases in Operations
4 Services' costs.

5 **Q. WHAT IS THE "TRANSMISSION ACCESS GROUP" THAT MR. KISSMAN**
6 **INTRODUCES AS THE SOURCE OF NEW DISTRIBUTION EXPENSES?**

7 **A.** The "Transmission Access Group" will be part of the new CPL-EDC and will perform
8 T&D access and contract administration activities. The Company forecasts expenses
9 associated with this group based on the cost of similar services currently provided to
10 wholesale customers. Mr Kissman states that while the Company had just 36 wholesale
11 customers in the historic test year, it expects that "up to 200 REPs" (Kissman p.50) will
12 require service by 2002 at an incremental total cost of \$1.7 million.¹⁵

13 **Q. DO YOU FIND THE COMPANY'S PROJECTION OF TRANSMISSION**
14 **ACCESS GROUP COSTS REASONABLE?**

15 **A.** No. The major reason is that the number of REPs will be much smaller than the 200
16 projected, and will probably be less than the 36 wholesale customers. This prediction is
17 based on observation of REP activity in other states that have actual experience with
18 retail access. The pilot program in New Hampshire attracted less than 30 suppliers
19 despite being the first of its kind in the nation. In Massachusetts, which has had retail
20 access for two years, 33 entities registered as providers but only a few are actually
21 functioning as such. In Pennsylvania, in the territory of the utility with the largest
22 shopping credits, there are only 14 entities offering to sell power to customers. In
23 Arizona there were several providers but I believe most of them have withdrawn. This is
24 consistent with the nationwide consolidation in the electric industry, and with what
25 appears to be significant economies of scale in the marketing function.

¹⁵ Amended Direct Testimony of Preston Kissman, page 50 and Exhibit DJL-4 to Amended Direct Testimony of Joe Lambright.

1 **Q. WHAT DO RECOMMEND REGARDING THE PROFORMA ADJUSTMENT**
2 **FOR PAYROLL AND NON-PAYROLL O&M COSTS ASSOCIATED WITH THE**
3 **TRANSMISSION ACCESS GROUP?**

4 A. If the Commission is inclined to allow an increase in O&M expenses for this activity, I
5 recommend that it be no greater than \$0.26 million, or 15% of the requested amount. The
6 proposed 85% reduction in expense for the Transmission Access Group is consistent with
7 30 REPs as opposed to 200. However, based on experiences elsewhere, my principal
8 recommendation is that no increase be approved for this adjustment.

9 **Q. WHAT ARE THE PRO FORMA ADJUSTMENTS FOR THE DISTRIBUTION**
10 **CUSTOMER SERVICES GROUP?**

11 A. Mr. Hooper claims that the Company needs to perform new activities in the registration
12 and billing areas. Although REPs will assume responsibility for billing, bill printing and
13 remittance processing, the Company argues that it will have incremental expenses
14 associated with "Premise Data Validation and Processing", "REP billing", "End-Use
15 Customer Registration Data Management", "Electronic Data Interchange Management",
16 and a number of other tasks associated with determining that data is correct. The
17 Company seeks an increase of \$1.6 million.¹⁶

18 My experience with the introduction of electronic data interchange (EDI) systems in New
19 England, to deal with far greater volumes of retail market transactions and with the
20 development of settlement systems for restructured wholesale markets does not lend
21 support to the proposed increase in O&M expenses. In fact, most Northeastern utilities
22 have restructured their business without any increase in delivery rates and some have
23 even agreed to T&D rate reductions.

24 **Q. HAS THE COMPANY DESCRIBED ACTIVITIES WHICH ARE TRULY NEW**
25 **AND WHICH WILL INCREASE COSTS?**

¹⁶ Amended direct Tesimony of David Hooper and Exhibit DJL-4 to Amended Direct Testimony of Joe Lambright

1 A. Very few of the Distribution Customer Services activities described are actually new.
2 Currently, the Company has responsibility for ensuring that billing data is accurate; it
3 summarizes daily billing for its own purposes, although not organized by REP; it
4 processes connect and disconnect orders; it resolves disputes over bills. It does not
5 currently have to communicate with REPs or account for customers switching REPs. Nor
6 does it have to interface with the ISO but it presumably does communicate customer class
7 information to its own control centers. It is also not clear exactly what its future
8 responsibilities may be. (Hooper p.29) In short, the Company has stretched the
9 definition of "new services" to justify this request for \$1.6 million incremental cost.
10 Accordingly, I recommend that this request be rejected.

11 **Q. WHAT ARE THE *PRO FORMA* ADJUSTMENTS RELATED TO CSWS'**
12 **OPERATIONS SERVICES ORGANIZATION?**

13 A. Debbie Potter describes four expense adjustments related to services provided by CSWS'
14 Operations Services. (p.27-30) These adjustments relate to telecommunications,
15 information technology, a Market Data Clearinghouse (MDCH), and PC leasing. The
16 total amount of these adjustments, including those incurred at the EDC and those incurred
17 by the CSWS shared services organization is \$4 million.

18 **Q. ARE THE SERVICES TO BE PRODUCED BY THESE ADJUSTMENTS**
19 **ACTUALLY NEW ACTIVITIES?**

20 A. For the most part, no. The very small telecommunications adjustment is related to the
21 separation of the Energy Management System and the SCADA system. The Information
22 Technology adjustment is to perform the new functions of REP registration, customer
23 enrollment and switching, bill estimation and reconciliation, financial settlement and bill
24 data deliver. Only the first two functions on this list might be viewed as new functions.
25 It is my strong expectation that there will not be large numbers of REPs with which to
26 interact. Only customer switching would seem to qualify as a real new expense and that
27 can be minimized through the use of EDI.

Q. WHAT IS THE MDCH?

A. In its original filing the Company proposed a capital addition to build an infrastructure to provide information services to REPs and "other market participants." In the revised filing, the Company is proposing to outsource these same functions to Logica, Inc. The cost to the CP&L EDC is \$3.6 million. Ms. Potter states that outsourcing the function is cost effective. This is based on a comparison of the cash expenditures from 2000 to 2004, and a calculation of a net present value savings. The relevance of expenditures over this period is not clear. If the Company installed whatever capital was needed, then it would presumably receive benefits from this investment well beyond 2004. In addition, there is a separate capital addition of \$770,000 that is also required by the MDCH. The conclusion about cost efficiency is not as clear if a longer horizon is used and the capital costs reported elsewhere are included.

Q. PLEASE DESCRIBE THE PC LEASE ADJUSTMENT.

A. Currently the Company purchases its workstations, and replaces them on a five year schedule. They are proposing to switch to leasing workstations, which will result in replacement every three years. Under the previous schedule, older workstations were rotated to employees that did not need the newest technology. This is an efficiency rather than a negative characteristic of the existing system. The net increase in costs claimed by the Company for switching to leases is \$137, 529. The Company claims that this change is beneficial, but the projected impact is an increase in costs. In other words, the Company has chosen to increase the cost associated with PCs with no showing that there are offsetting cost decreases or benefit increases.

Q. DOES MS. POTTER SPONSOR ANY OTHER ADJUSTMENTS?

A. Yes. She describes two one-time or capital costs related to Information Services caused by business separation. These are modifications to Customer Information and Meter Records and also Market Data Clearinghouse Integration. (Potter p.34) These total \$2.5 million for CPL.

1 **Q. WHAT IS YOUR RECOMMENDATION REGARDING THE EXPENSES**
2 **SPONSORED BY MR. HOOPER AND MS. POTTER THAT THE COMPANY**
3 **CLAIMS ARE REQUIRED FOR THE TRANSITION TO COMPETITION?**

4 **A.** I recommend that none of these adjustments be allowed. Very few of these appear to
5 actually require new activities. Nor has the Company projected savings from functions
6 that they will no longer perform or efficiencies in the restructured system. In some cases
7 the adjustment is described as made for efficiency but the end result is a cost increase.

8 Aside from the specific objections that I have raised above, it is unreasonable that
9 unbundling these very large entities, and directing them to perform more specialized
10 activities, should cause large increases in costs. Even if there may be some short-term
11 costs of adjustments, I would expect that the TBU and DBU should be able to increase
12 the efficiencies of their organizations. I have encountered many utilities that have
13 claimed a need for such expenditures, although none of them have been of the magnitude
14 claimed by CPL. However, in many if not all cases these claims have been rejected, and
15 the utilities still introduced competition and continued to operate successfully. In
16 Massachusetts, all utilities were required to provide retail access with not only no
17 increase but with a decrease in their total rates. The same was true for Public Service
18 Company of New Hampshire, and for the private utilities in California. In Pennsylvania
19 all utilities are providing retail access and all of their distribution rates have been frozen
20 for 4 or more years. In Maryland, utilities have provided retail access with no
21 distribution rate increase. In Arizona, Arizona Public Service and Tucson Electric Power
22 Company have decreased their distribution rates while providing retail access. This leads
23 to the conclusion that either all of these utilities were previously over earning, and thus
24 could afford to institute new systems, or the net cost (less revenues) of those systems was
25 not very expensive, or that the companies have been able to institute efficiencies that
26 compensate for any new costs.

27 **Q. IN ADDITION, THE COMPANY HAS PROPOSED TWO ADJUSTMENTS TO**
28 **TEST YEAR REVENUE REQUIREMENTS AS A RESULT OF IT CEASING TO**

**PROVIDE NON-ROADWAY PRIVATE LIGHTING SERVICES. PLEASE
DESCRIBE THESE ADJUSTMENTS.**

A. The Company has requested an exception to PUC Substantive Rule 25.343 to allow it to continue to provide non-roadway lighting services to existing customers through December 31, 2006 at regulated rates. In order to recover its net investment in lighting, the Company has proposed to include an adjustment to test year O&M costs that reflects the additional depreciation needed to fully depreciate the equipment by year end 2006. The increase in depreciation would be charged to all customers taking distribution service, not just non-roadway lighting customers. In other words the Company is treating the remaining plant on the books as a stranded cost that should be paid for by all customers. During this accelerated cost recovery period, the Company states it will seek a third party buyer for its lighting business.

Q. DO YOU AGREE WITH THE COMPANY'S PROPOSALS?

A. No. The Commission should reject the Company's request for a waiver and instead direct it to immediately seek a buyer for the assets and use the proceeds to write down the net investment. In this case, the Company will no longer incur costs associated with the service, nor will it receive revenues from the service.

The Company expects that other providers may take over this service. To take over the service, they will need to purchase the facilities. If they do not, the property owners themselves may be willing to purchase the facilities. I would assume that these facilities could be sold for the remaining book value, so that no writeoff would be necessary. As a result, I recommend that the Commission eliminate the \$2.5 million adjustment to accelerate the recovery of the lighting equipment investment. If the Company ceases to provide the service at the retail access date, the net book value of this plant will be greater, but so will be its market value, since it will be 5 years younger. Again, the book value should be recoverable through the sale price.

1 **Q. WHAT IS THE IMPACT OF THESE RECOMMENDATIONS ON THE**
2 **ALLOWED REVENUE REQUIREMENT?**

3 A. Distribution expenses should be reduced by \$13.5 million . The sum of these adjustments
4 is shown on Exhibit LS-2.

5 **B. Capital Additions**

6 **Q. HOW LARGE ARE PROPOSED DISTRIBUTION PLANT CAPITAL**
7 **ADDITIONS?**

8 A. The Company projects distribution plant additions of \$219 million, or 18.6% of the
9 historic original book value of distribution plant.

10 **Q. DOES THE COMPANY INCLUDE PLANT ADDITIONS THAT THEY CLAIM**
11 **ARE RELATED TO SB7?**

12 A. Yes. The Company is requesting \$12.6 million due to creation of the new EDC. This
13 includes physical separation of employees, additional IT and telecommunications
14 equipment, separation of the IT systems, and development of new IT systems to support
15 settlement. This adjustment is presented as a discrete restructuring cost line item under
16 rate base.

17 **Q. IS THIS THE TOTAL EXPENSE ASSOCIATED WITH THE UNBUNDLING OF**
18 **THE EDC?**

19 A. It appears to be the total expense. Mr. Kissman describes these as capital investments
20 which EDC will incur for CPL. (Kissman p.44)

21 **Q. IS THIS AN APPROPRIATE ADJUSTMENT?**

22 A. No. These costs should be borne entirely by the non-regulated functions, which will have
23 the ability to reap future benefits from competition. These separation costs may
24 contribute to addressing the imbalance between new REPs which have to establish full
25 organizations, and any CPL generation affiliate, which has the advantage of an existing
26 organization. If the Commission chooses to allow some separation costs, this item should

1 be allocated between regulated and nonregulated functions. According to Order 17,
2 restructuring costs should "be treated according to traditional rate-making principles."
3 These would dictate, that at a minimum, these costs be allocated between regulated and
4 non-regulated functions using an appropriate A&G allocator. However, my
5 recommendation is to decrease rate base by the full \$12.6 million.

6 **Q. WHAT WAS THE BASIS FOR THE FORECAST PLANT ADDITIONS?**

7 A. Mr. Kissman lists 9 different causes of plant additions, of which 7 apply to distribution
8 plant. (p.52) Additions other than repairs and replacements were forecast based on
9 history, increased by an estimate of work needed to comply with new reliability rules.

10 **Q. DOES THE COMPANY PROJECT AN INCREASE IN TRANSMISSION RATE**
11 **BASE?**

12 A. Yes, the Company forecasts transmission capital additions of \$386 million and
13 retirements of \$31 million.

14 **Q. TO WHAT DOES THE COMPANY ATTRIBUTE THE INCREASE IN**
15 **TRANSMISSION PLANT?**

16 A. As noted earlier, Mr. Kissman describes a multitude of reasons. The only such reasons
17 that are clearly new because of restructuring are requirements to interconnect new
18 wholesale generators and to improve grid reliability at the direction of the ISO.

19 **Q. PLEASE COMMENT ON THE PROPOSED INVESTMENTS.**

20 A. A number of the proposed investments to improve reliability and connect wholesale
21 generators are still quite speculative, and should not be allowed in rate base until the
22 investments are actually made. Any delay in the permitting process or construction could
23 easily delay the in-service date of transmission additions by a year. I recommend that,
24 due to the high degree of uncertainty of plant investment in the later years, the
25 Company's requested 2002 additions of \$58.5 million not be allowed.

1 **Q. ARE YOU CONCERNED WITH THE COMPANY'S LEVEL OF INVESTMENT**
2 **IN THE EARLY YEARS?**

3 A. Yes. I am particularly concerned with the projects the company attributes to grid
4 reliability and constraint relief. The Company's response to COPS' RFI 2-3 indicates
5 that, in the test year, \$6.8 million was spent on reliability and constraint relief projects.
6 The Company goes on to show the level of investment rising to \$86.5 million in 2000 and
7 \$79.7 million in 2001, a 12 fold and 11 fold increase, respectively. I find it difficult to
8 believe that grid constraints will become so severe as to require a total of \$166 million in
9 new transmission investment in the span of only two years. The investments in grid
10 reliability are intended to enable additional competitive transfers of power as retail access
11 is initiated and the volume of transactions increases. This process will take place over a
12 number of years. Moreover, it seems very unlikely that the Company has the ability to
13 increase its rate of transmission construction this dramatically.

14 **Q. WHAT IS YOUR RECOMMENDATION REGARDING THE LEVEL OF**
15 **INVESTMENT IN RELIABILITY AND CONSTRAINT RELIEF PROJECTS?**

16 A. I recommend that transmission plant be increased based on the assumption that
17 investment over the next two years remains at a reasonable level compared to the historic
18 year. An investment level of even double the historic year will allow for a reasonable
19 increase in constraint relief projects and is still significantly less than the Company's
20 request. Therefore, I recommend that the level of reliability and constraint relief
21 investment be allowed at \$13.6 million for 2000 and 2001.

22 **Q. ARE THERE ANY TRANSMISSION PLANT ADJUSTMENTS THAT ARE NOT**
23 **TO LINES AND SUBSTATIONS?**

24 A. Yes. They are claiming an adjustment of \$3.6 million for new transmission meters,
25 because they expect the Commission to adopt a "requirement for transmission metering at
26 all power plants." This is not yet a requirement. It would seem that transmission
27 metering will add very little value to the system, as there is metering on the generation
28 side of the transformer and metering on the input to distribution systems. This

1 adjustment should be rejected.

2 **Q. IF YOU HAVE NOT ADDRESSED AN ISSUE, DOES THIS IMPLY THAT YOU**
3 **ACCEPT THE COMPANY'S COST?**

4 A. No, it does not. The proposed increase in taxes other than income taxes appears
5 inordinately large. Also, a number of costs should be decreased as a result of the
6 recommendations that I have made. I have not calculated the reduction in income tax
7 that will result from the lower rate base, or the reduction in working capital that will
8 result from the reduction in expenses.

9 **Q. HAVE YOU SUMMARIZED YOUR REVENUE RECOMMENDATIONS?**

10 A. Exhibit LS-3 shows each of the discrete adjustments which I have made. I have not
11 calculated the reduction in income tax that will result from the lower rate base, or the
12 reduction in working capital that will result from the reduction in expenses.

13 **Q. DOES THIS CONCLUDE YOUR TESTIMONY.**

14 A. Yes.